RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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January 14, 1981 **LETTER 800**

Dec. 2, DJIA 972.78; PTI 1390; A-D Ratio –17.42
Dec. 9, DJIA 968.69; PTI 1394; A-D Ratio –17.51

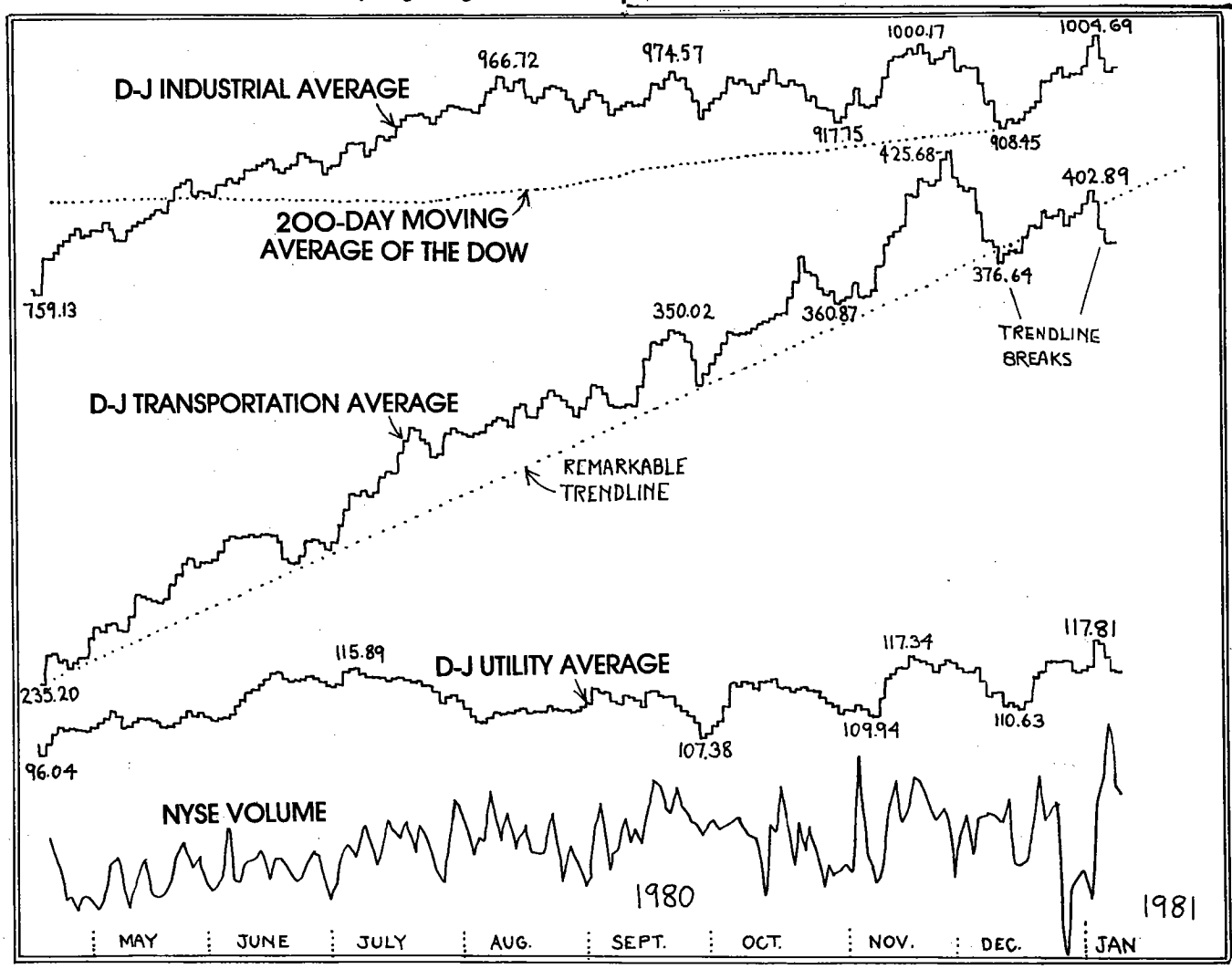
THE PICTURE: Back in the 1950's John McKee, a pioneer stock market technician, was fond of saying, "Don't bother me with facts, my mind is made up." John would look at a chart, and it was his thesis that everything pertaining to a given stock was built into that chart. So John didn't want to be confused by earnings projections, sales, debt ratios or anything else. And I used to think the same way back in those halcyon days.

But times have changed. You and I are not simply trying to beat the market today. And we are not just trying to invest intelligently today. The fact is that our whole way of living is on the line, to say nothing of our political system and our very freedom. Therefore, I find myself today thinking about the value of the dollar, the price of gold, the trend of food prices, the Social Security System, the concept of the safest place to live, how Government policies will affect my kids, and on and on. No longer is the trend of stocks and the market the single most important thing in my life (at one time I blushingly admit that it was).

I've said this before, and I want to repeat it. I feel that I can only make one SURE statement today regarding the future.

FRONT PAGE COMMENT: On the night of January 6 Joe Granville sent out a "sell out and sell short" message. Many people were angry, calling Joe a nut, a tout, a national menace. Others insist that Granville single-handedly sent the market reeling. To which I say, "Nonsense, forget it!" Joe Granville is one of the most creative and most intuitive analysts in the business, and he could perfectly well see what a number of analysts could see. What he saw was that the daily new highs on the NYSE had dropped off on the rally to the January 6 Dow high of 1004.69, the breadth had deteriorated horribly, the major composite Averages did not confirm the Dow, plus a half-dozen other danger signals. Granville didn't knock the market down, he simply acted on what the market presumably was telling him.

In Letter 797 I quoted friend R.E. McMasters as follows: *"It takes a disciplined and mature trader to know where a market is going, and still stay out because he can't handle the risk. In such an environment, as the present one, every man must search his soul..."* As subscribers know, I constantly search my own soul, and my personal position was revealed in the "Investment Position" box on page 5 of the last Letter. That position was, and is, T-bills.



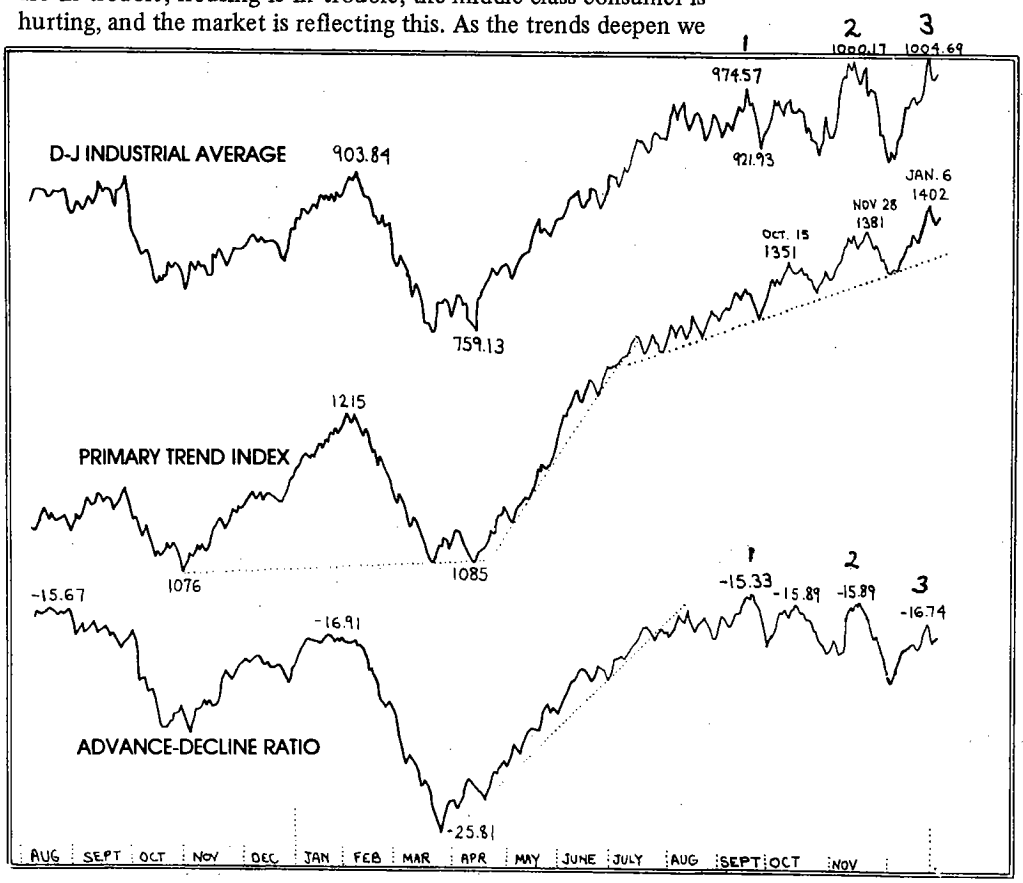
And that statement is that *our standard of living is going to decline.* I make that statement regardless of whether the bull market in stocks continues - or whether a bear market comes in. US prosperity has always been predicated on four remarkable phenomena: (1) Cheap energy, (2) cheap raw materials, (3) cheap money, (4) an ever expanding frontier. Today, all four of those phenomena are gone, things of the past.

Because all four of these items have disappeared, I am convinced that the US standard of living must come down. Furthermore, the steadily expanding world population will want (and I mean each individual will want) a larger share of the economic pie. This means more pressure on what is mined, what is manufactured, what is grown. This pressure will lead to higher prices and less to go around. UNTIL – deflation finally takes over.

I might add that there are two premier growth industries in the US today. The first is debt and the second is corruption. And in my mind they are definitely inter-connected. If President Reagan follows his election-platform promises, he is going to run head on into both of these. What he can do about them remains to be seen.

Question: Russell, has all this been reflected in the market?
Answer: Yes, I think it has, and the place where it can best be seen is in the A-D ratio. The A-D ratio recorded its bull market high on September 11, 1978 at minus 14.85. Then in Sept. of 1980 the A-D ratio recorded a lower peak at minus 15.33 (see chart). In November the A-D ratio recorded a still lower peak at minus 15.89. All this occurred against successive highs in the Dow. What is the market telling us?

I think what we're seeing (as pin-pointed by the A-D) is a situation wherein fewer and fewer stocks and industries can prosper during this period of high interest rates and rising inflation. Autos are in trouble, housing is in trouble, the middle class consumer is hurting, and the market is reflecting this. As the trends deepen we are going to see the great middle class squeezed more and more, and this will first affect high-ticket spending (which is now happening in autos and housing) and then the lower ticket items (restaurant meals, appliances, furniture, etc.). This is what I see in the period ahead, and this is what the market is telling us via the A-D ratio. By the way, *this is the longest period of A-D divergence (16 months) in modern history.*



THE MARKET: In the last Letter I noted that despite the November-December market slides the Transports would not confirm on the downside. "The price structure, although battered, remains very much intact," I added.

From the December 11 lows, the Averages moved up sharply. By December 6 Industrials closed at a four-year high of 1004.69. (see chart, page 1). But the previously explosively strong Transports *failed* by a wide margin to confirm. Under Dow Theory, this flagrant non-confirmation flashed a danger signal. The danger was heightened by the surging volume of January 6, 67.4 million shares, the ninth biggest volume day in history.

As an aside, observe on the page 1 chart that the Transports since December 11 had lost momentum and were walking up the *underside* of their long ascending trendline.

It was notable that on January 6 with the Dow at a new recovery high, none of the major composite Averages (i.e., the D-J 65 Stock Average, the Standard & Poor's 500, the NYSE Index) confirmed. All closed below their recent November peaks. Thus we saw a reversal of the November situation. In November all the major composites recorded new highs, but it was the Dow which failed to confirm. The November situation was bullish in that the broad market was stronger than the Dow. The January 6 situation was negative in that the bulk of the market had refused to confirm the strength in the thirty Dow Industrials.

Conclusion: From the standpoint of Dow Theory, nothing has been proved yet. We have a failure to confirm on the upside on the part of Transports and that's all. BUT, if the two Averages turn down and break their preceding lows on expanding volume, a primary bear signal will have been given. The preceding lows are 908.45 for Industrials, 376.64 for Transports.

PTI, A-D RATIO: As you can see on the page 2 chart, December 6 saw the Primary Trend Index (PTI) move up to a record high of 1402. This marked the fifth rally from the rising trendline. The Dow moved up to a recovery high of 1004.69 on the same day. But on January 7, amid record volume, the market tumbled. The sell-off continued on January 7, although the downside pressure abated.

Conclusion: From the standpoint of the PTI, nothing has been proven yet. The rising PTI trendline is now at approximately the 1364 level, 26 points below the current actual level of the

PTI. Thus, it would require persistent market weakness of another week or so to reverse the major trend direction of the PTI.

At this point I want to discuss the Advance-Decline ratio (see chart). The A-D ratio takes into account the daily advances and declines of ALL Big Board issues; thus the A-D ratio is a proxy for the entire NYSE.

Since last September, the A-D ratio has been diverging with the Dow, and this is a sign of technical deterioration. Note that we have seen three successive highs on the Dow (labeled 1,2,3 on the chart) accompanied by three successively lower peaks on the A-D ratio (also numbered). This rare and rather bearish phenomenon tells us that since September, the mass of stocks on the NYSE have been unable to keep pace with the Dow. Such action has preceded many major bear markets. Whether this is to be another such instance remains to be seen.

Question: Russell, what about the January 6 high in the PTI? How does that jibe with a bearish A-D ratio and a declining market?
Answer: You have probably noted that I interpret the PTI on a trend basis, and I constantly talk about a trend holding intact or a trend reversing. One of the greatest uses of the PTI is its ability to avoid whip-saws, to avoid one-day or even one-week shakeouts. The PTI was not designed to give "buy" or "sell" signals on the basis of a one-day pop or a two day sag. It was designed to do just what its name implies – *follow the main or primary trend of the market.*

The deteriorating A-D ratio, the drop-off in new highs, the weakness in the composite stock Averages all tell us that the market has been running into difficulties. The historic break of January 7 was another potential indication of trouble. Now I am watching the PTI, because the PTI is going to tell me HOW MUCH TROUBLE. I will be watching to see whether enough weakness is generated in the period ahead to take the PTI below its ascending trendine – or whether this is just another shakeout during which the PTI continues to hold above that ascending trendline.

MONEY RATES: Fresh estimates from the US Office of Budget and Management indicate that Federal spending will move up from the predicted $632 billion to probably $662 billion. This is causing Reagan people to weigh cuts in social aid, trimming cost-of-living clauses or eligibility requirements.

My own guess is that the 10% tax cut slated for 1981 will come into question. A 10% tax cut means immediate loss of tax revenue to Government. But the gain to consumers could easily be saved (rather than spent). Even if spent, the expected pick up in the economy from the consumer will be slow in coming while the short fall to the Treasury will be fast. Result: even bigger deficits.

The result of this pressure is going to be continued upward pressure on interest rates. The rate of currency creation needed to keep this economy going is far above current levels, but new highs in inflation rates are politically unacceptable. So my own outlook for 1981 is high interest rates, deficits, a continued squeeze on the consumer and lowered standards of living.

The Reagan team will be struggling with massive budget deficits and therefore the necessity of cutting into all sorts of "sacred cow" programs. I repeat: the Russell gauge for "How well the Reagan Administration is doing" will be the amount that the Reaganites can slice, hack and chop off the Federal Budget. If they fail to decimate the budget, they will fail!

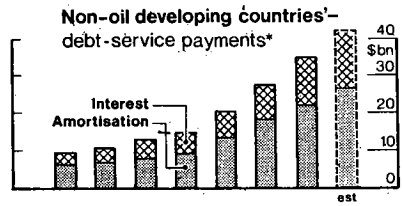
In 1979 the US Treasury raised $38.3 billion in new money. In 1980 the US boomed the amount of new money-borrowing to $92 billion, an all time record. For 1981 my guess is that the same or more (i.e., over $90 billion) in NEW money will be needed. Many subscribers do not understand what I mean by "new money." New money is what is needed ABOVE the regular maturing bills, notes and bonds. In other words, if $100 billion of various bills, notes and bonds are to mature in 1981, this amount must be "rolled over" so the funding can remain intact. New money is the amount needed above that which is maturing. That new money must be obtained from the sale of new maturities to institutions, foreigners and the US public.

Based on the continuing needs of the US Treasury, my guess is that interest rates are going to remain high during 1981. Obviously there will be the usual fluctuations, the usual rallies and declines, but the pressure will be on the upside, and that is the guiding fact in the money markets of 1981.

NOTES & QUOTES: Mr. X, a San Diego friend of mine for 20 years, is a publisher of leading military-industrial data and fact material. What he told me last week is a shocker. For 1981, said X (he obviously does not want to be identified), military salaries and pensions will be up about 11%. Roughly 70% of the military budget consists of salaries and pensions while about 30% of the budget goes to actual hardware (weapons and weapon systems). But spending for hardware during 1981 will be DOWN roughly 4-4.5%. Thus, despite the fact that the overall defense budget will be up, spending for weapons will be down!

Furthermore, said X, engineers are now becoming a glut on the market and advertising for military technicians and engineers is declining. X told me that the MX and B-1 systems are both being given a low funding rate; they will be stretched out and in all likelihood dumped. Finally, X told me that there are no new weapons systems now on the drawing board. *"Within six months,"* added X, *"you will be seeing the contraction in the weapons supplying companies. Some companies are already laying off people, and there has been little or no expansion of facilities among the major suppliers."*

* *



Incredibly, money is now dearer than oil. To explain, the rising trend of interest rates is now costing the "less developed countries" more than the rising cost of oil. The LDC's who don't produce their own oil now have about $100 billion of floating-rate debt. So every rise of 1% in interest rates cost these nations an additional $1 billion. This little chart (from the London *Economist*) shows how the debt has been rising for the LDC's (note the explosion in interest payments). This is the path to international bankruptcy, and the path is moving upwards!

* *

Did you ever wonder what happens during hyper-inflation? Here's what's happening in Argentina, where conditions have actually been improving under strongman General Videla and his new economic order: Prices this year have doubled and businesses and industries are folding at a record rate. More than 20 banks

have gone to wall with more failures predicted. Money is leaving the country at the rate of $50 million a day, and interest on borrowed money is over 100%. The mainstay of the economy, grain and meat exports, are down 30% and unemployment is rising ominously. All of this came out of Juan Peron's economic fascism and his policy of pleasing the people while retaining his power (sound familiar?).

* *

Non-Surprise Of The Week: This from the new Director of Office Management and Budget, David Stockman: *"It's clear now that the budget is $60 billion in deficit (for the year ending Sept. 30) that spending has increased $45 billion over what was projected in June and that the problem of trying to control that is going to be even greater than we expected."*

Government Finances

WASHINGTON (AP)-Here are figures on government spending and debt (last six digits are omitted). The government's fiscal year runs from Oct. 1 through Sept. 30.

Total public debt Jan. 5	(932,113)
Interest on public debt Nov	6,069
Interest fiscal year thru Nov	12,028
Projected deficit fiscal 1981	29,766
Actual deficit fiscal 1980	58,961
Receipts fiscal year thru Nov	78,098
Receipts period last year	71,419
Outlays fiscal year thru Nov	104,354
Outlays period last year	94,544
Gold for Sept.	11,168

* *

There are 574 thousand millionaires in the US (assests of over $1 million) or one out of every 394 people. The average increase in millionaires over the past 10 years has been 14.7%, but last year's increase was only 10.3%. So it's getting harder to be a millionaire. New York had most millionaires (56 thousand) with California second (38 thousand). But in density, Idaho led with 26 millionaires per 1000 residents followed by N. Dakota with 8.8 per thousand.

* *

Et Tu, California: A few years ago California had a $4 billion state surplus. That surplus is under $1 billion now. And the state is now running a deficit of $200 million a month. At this rate, California will face a crisis by late 1981.

* *

"Whom the gods would destroy, they first make mad." If world military spending of $480 billion ($1.3 billion a day!) isn't total madness, I don't know what is. Furthermore, the greatest part of these expenditures are transacted on credit. The insane arms build-up is slowly but surely busting the world including both Russia and the US.

World military expenditures reached about $480 billion in 1978, the latest period for which figures are available, and are continuing to rise, the U.S. Arms Control and Disarmament Agency said. Spending by North Atlantic Treaty Organization and Warsaw Pact countries was roughly equal and accounted for 75% of the total, the report said.

* *

What people read and what they see at the movies probably constitute the best reflection of the psyche of the nation. Along these lines, I thought these comments from the Dec. 30 Los Angeles Times amusement section were well worth repeating:

If there seems to be a pattern to the above success stories, it's that moviegoers don't want to tax themselves too greatly. All the leading films are either comedies or musical comedies, with the more serious efforts ("The Competition," "The Formula") being left in the lurch.

"This is a very scared country right now," observed one marketing executive for a major studio. "People don't want reality—they just want to laugh."

* *

In case you are wondering, I am in favor of citizens without felonious records being allowed to own handguns. All over the nation homicide rates are skyrocketing. Murders are up 20% in Los Angeles, and you might study this paragraph from last week's LA Times piece on "senseless killings." Put it this way: with a wife and two small kids I don't want to find myself unarmed and confronted by a "hophead" in my house who is armed and disinterested in our staying alive.

LOS ANGELES (UPI) — A series of coldblooded murders have sent a winter chill through this sun-drenched city and psychologists fear the trend of senseless killings committed by "walking time bombs" could spread across the nation.

As the New Year approaches, residents of the country's third largest city are scared. Not only are homicides at an all-time high — up 20 percent over last year — but it also appears that the long-held idea that cooperative victims are less likely to be harmed has been shattered.

* *

Editors of US daily newspapers listed these as the top stories of 1980 in order of significance. For 1981, I suggest that number 2 could move to number 1.

1. The Reagan election.
2. Inflation and the economy.
3. Hostages in Iran (including rescue mission).
4. Iran-Iraq war.
5. Polish workers strike.
6. Cuban refugees.
7. US racial unrest.
8. Abscam-Brilab scandals.
9. Voyager I close-up photos of Saturn.
10. Olympic boycott.

INVESTMENT POSITION: In the last Letter I discussed risk/reward, so there's no sense repeating that thesis. Over an extended period of time, most funds and money managers are lucky to make 10% compounded. That tells serious investors an awful lot about today's markets.

Let me put it another way. The yield on the S&P 500 stock average is 4.67%, the yield on the Dow is 5.59%. Against this I can get a yield of 12.36 on Aaa rated bonds, over 11.2 on Treasury bonds, and over 14% on T-bills. On the basis of safety and return on investment, stocks are over-valued in relation to money instruments. This is the reason I have been telling my subscribers to stay with T-bills.

The argument for stocks has to do with inflation. With gold under 600, all eyes are now on the stock market. If we get a bear signal (Industrals under 908.45, Transports under 376.64) the inflation argument will become tenuous at best. In that case, there will be a rush for the one item nobody has – cash. I'd like my subscribers to be there (in cash or T-bills) first!

ON MY MIND: There's one question that comes back to haunt me again and again, and I might as well go into it now. I know that at some point ahead the debt of the US will overcome everything including inflation, and at that time America will be faced with one of its worst financial crises ever. That crisis could come in a year or five years – but it WILL come.

"But," you ask, "why can't the US just inflate forever? Why do we have to stand still and let our debts swamp us?" And my answer is that inflation cannot extend indefinitely for a number of reasons. (1) The median age in the US is moving higher and higher. This older population votes, and it will not stand for perpetual inflation. It won't stand for it because the older segment of the population tends to be conservative and it also has the hardest time trying to adjust to inflation. (2) In order to handle our rising debts, the RATE of inflation has to rise with each cycle. We are now at the stage where any spate of inflation is

immediately translated into a run on the dollar. A run on the dollar brings high interest rates and a collapse in the bond market. A collapsing bond market sets off a falling stock market and that together with higher interest rates brings on deflation.

So, somewhere ahead I believe the US is going to face the brick wall of deflation. Throughout history, all paper currencies have wound up on the inflation path. Throughout history, each inflation binge has given way to ultimate deflation or collapse or both (often with a fall of the government and a change in the political system). We are headed for that in the US. It's a question of when, not whether.

Everyone reading this Letter is faced with the same ultimate problem. What do we hold when inflation finally hits the wall? Should we hold gold, dollars, foreign currencies, land, real estate, collectibles, stocks? Is there any answer?

At some point ahead the nation is not going to be able to handle the cost of servicing its debts. This point will come during a recession when the public is so discouraged or frightened that no amount of governmental stimulation will bring them (the public) to buy above the bare necessities. Business volume will slump, profits will dive and at that point the debt will start sending corporations (and individuals) to the wall. Undoubtedly, the Government will try everything. They will buy up corporate bonds, they will support bankrupt corporations, they will announce work programs, they will spend and spend. But the primary trend of the market and the economy will be down at that time, and all the Government's actions will be like willows pushing against the wind. The Government will fail miserably.

Next, the price of "things" will start sagging as inventories are thrown over at any price they will bring – all in an effort to increase liquidity. Sensing a long trend of lower prices and fearful because of unemployment, the public will go on a buying strike. At that point, the economy will start unravelling and distress and bankruptcies will be rampant. At the same time, cash will start buying more – and more and more.

Then rumors may start to the effect that the US Government itself will not be able to finance its spending. Because of foreign holdings of dollars, monetization of the debts will be limited, and the Government will have to raise ever-increasing amounts of cash in the money markets. But the money markets will not be able to handle the new demands for money, and interest rates will sky-rocket. In the face of this, the price of everything will start to crumble as cash becomes king.

Questions about the very existence of the dollar will arise. Rumors will multiply: "The US has exhausted its taxing power," "The dollar is doomed." "Too much debt, and no way of servicing it." Gold, in a quandary, will run up, then sag, then rally again as it is torn between the need for ultimate safety (real money) and the forces of deflation that are sending ALL prices to lower levels. In such an atmosphere, I ask myself, what should one be in, what should we be holding?

And the terrible thing is that I can't come up with the ultimate answer! And neither can anyone else. I've said this before, and I want to repeat it. We, the people, vote for our leaders, our politicians. Politicians may not be much, but they are very sensitive to one thing – votes. In order to get those votes, they MUST be sensitive to what the people want. And since our politicians for the last 40 years have been spendthrifts, it follows logically that the American people have wanted big spending, free lunches, big government and avoidence of pain and anxiety at all levels. But with all those free goodies comes that monster – inflation. So consciously or unconsciously, Americans have voted inflation in. They wanted the good life, and they wanted it now. The good life, unfortunately, is an American euphemism for debt and inflation. We've got it, and as night follows day, we'll pay for it.

So the thing I want to repeat is that NOBODY IS GOING TO COME OUT OF THE INFLATION EXPLOSION WITHOUT SUFFERING AND LOSSES. I predict that all the pain that Americans have tried to avoid via the debt build-up and inflation will ultimately envelope them – first in the terminal stages of inflation and finally in deflation.

Furthermore, I personally feel that the only protection against what I see coming up is intelligent diversification. I believe in diversification (and I have acted on it myself) because I don't think there is any way of foreseeing how things will ultimately work out, what the government will do, what the voters will do, what the market will finally do. Thus, I offer my scenario for the ultimate collapse of inflation, and I offer the imperfect solution – diversification.

As for diversification, I advise you to own a home (the only asset that you live in), I advise you to own your own business if at all possible, I advise ownership of some collectibles (and this category will require a good deal of study and perhaps the services of an expert). Not everyone can be in these three, but if you can, I'm all for it. Finally, at this stage of the game, I advise lots of cash.

NOTICE: I still have the big chart books covering the daily D-J Averages (Industrials, Transports, Utilities, volume, and the D-J Bonds going back to 1896. These are large chart books with one page devoted to each year. Major events of each year are also notated. I know of no better way to study stock market history than with one of these chart books. Price (hard cover, 3-ring binder) including postage is $49. For California subscribers the price is $52.

The new 1980 pages will be ready in a few weeks. For those who want to update their D-J Average chart book the price is $2.50 per page. I will also have the new pages for the A-D ratio chart books (this book is no longer available) and these pages are also $2.50 for the 1980 insertion. (My thanks to Jon Strebler of Drexel Burnham for drawing these charts for me.

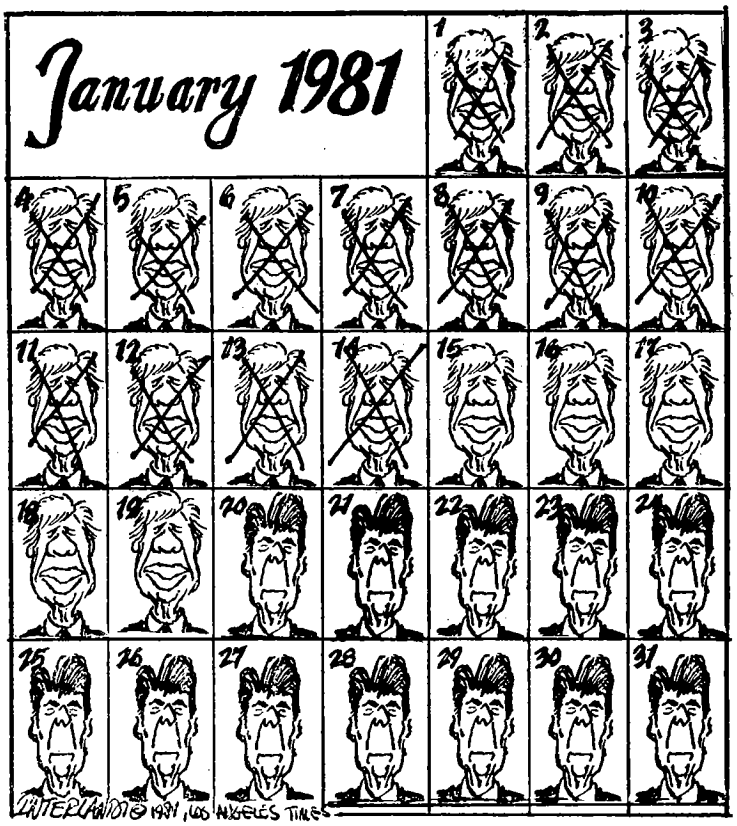
GOLD: Many of the former (and belated) gold bulls have now turned bearish on gold. The fashionable view is that "gold is in a major bear market." Maybe so, but I'm not fully convinced. In my speech at the last New Orleans Conference I did state that gold was in a primary bear market, and at the time that statement did seem shocking (so much so that I hesitated to say it). But now my New Orleans view has become the general view.

So, stubborn cuss that I am, I am now taking a neutral stance on gold. That means that I'm going to let the market prove to me that the bears are still in control. As you can see on the chart, gold is still holding within its long, declining channel. I don't think it's going to break the 553 low so quickly, and it seems to me that the most important level for gold is that upper channel line – which is now at about 590.

If I were pressed to make a prediction, I would say that gold will be locked into a 525-625 trading range for an extended period of time. I say this because I have seen plenty of selling at around 625 and good support in the 535-550 area. My guess is that the gold picture will continue that way for a while.

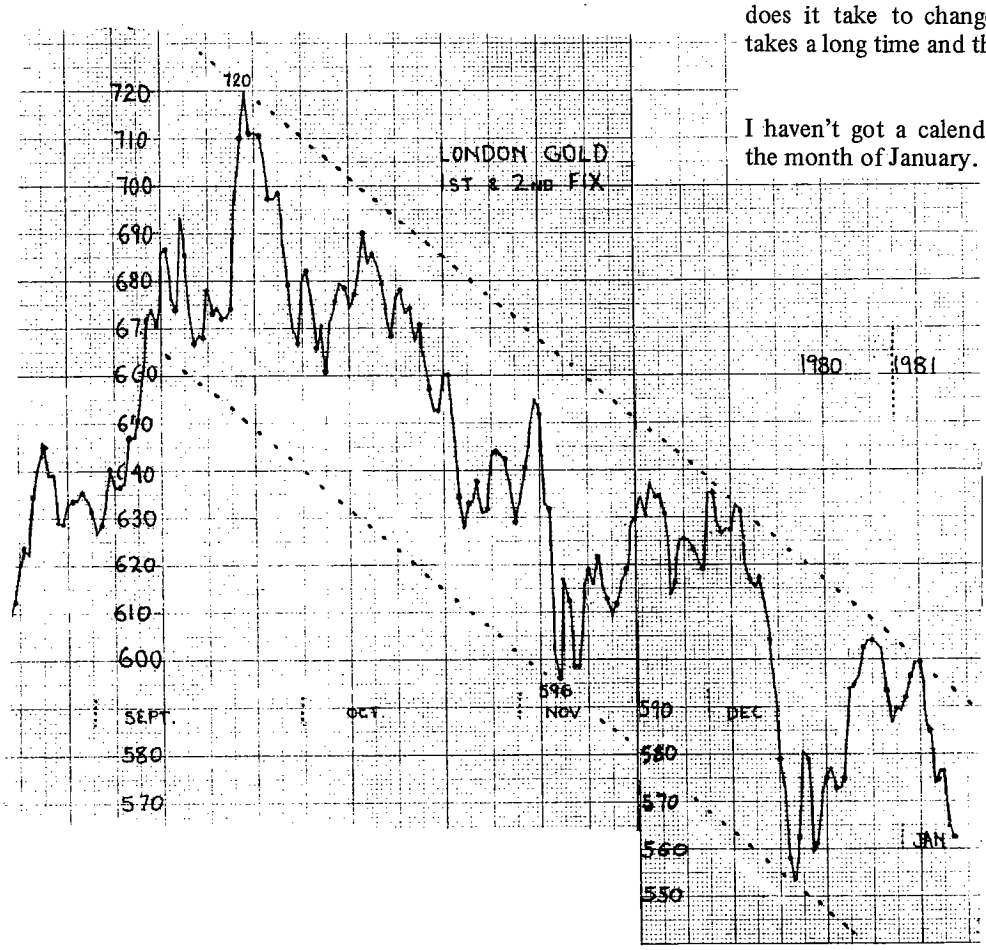
For the record, gold momentum (13 week rate of change) was 86 last week, and this obviously means that the weakness in gold continues. The 50-week moving average (MA) of gold now stands at 589, so spot gold is below its long-term MA. The 13-week MA for gold stands at 609; the 5-week MA for gold is 591. Any real turn in gold will see the 5-week MA climb above the 13-week MA. That has not happened yet.

LATE NOTES: Friday (Jan. 9) gave me a plus reading on the PTI and I must say that looking at the PTI alone would suggest nothing very bad is happening in this market. But I want to give the PTI another week or so to see whether it establishes a true downtrend. So far, not too much on the downside from my trusty indicator, and this could mean that the shorts will be sweating again before the month is out.



C'MON, it's time for some humor. How many psychiatrists does it take to change a light bulb? Answer: only one, but it takes a long time and the bulb must want to change.

I haven't got a calendar for the whole year, but here's one for the month of January.



FINAL NOTE: Want to get rich? It's easy, just follow what the majority of experts tell you to do, as outlined in the WSJ (Jan. 21). Here's a squib from an article from the Journal. Their best bets? Buy bonds and sell gold short. My own best bet, bonds will not be a buy, and it will be hard making money on the short side in gold.

Rating the Commodities

Here are the top choices of senior commodity specialists for futures investments in the next six months. To rank them, three points were given to a first choice, two points to a second choice and one point to a third choice.

Contracts	Points
1. Buy Treasury bonds	20
2. Buy corn	14
3. Buy soybeans	11
3. Buy cattle	11
5. Buy cotton	9
6. Buy sugar	8
6. Sell gold	8

NEXT MAILING: January 28th